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Shanghai Leads the Way in the Further Development of Foreign Participated RMB Funds

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The formalization at the beginning of this year of a trial program proposed in March 2010 by the Shanghai Municipal Government to the central Government relaxing restrictions on conversion of foreign currency capital contributions appears to have further opened the door for foreign participation in RMB funds.

The long awaited *Implementation Measures on the Pilot Program of Foreign Invested Equity Investment Enterprises*, also known as the "Qualified Foreign Limited Partner Rules" (the "QFLP Rules") came into effect on January 23, 2011. The QFLP Rules provide for a qualification system that will allow both qualified foreign fund sponsors and foreign invested RMB funds to convert foreign currency into RMB.

Background

In the past, foreign fund managers have sought through various structures to circumvent the foreign exchange restrictions in China. However, since 2008 when the State Administration of Foreign Exchange ("SAFE") promulgated the *Circular on Relevant Operating Issues Concerning the Improvement of Administration of Payment and Settlement of Foreign Capital by Foreign Invested Enterprises* (commonly referred to as "Circular 142"), the ability to structure foreign participated RMB funds has been problematic. Circular 142 provides that RMB settled from registered capital of a foreign invested enterprise shall only be used for the approved specific business purpose. Since it has been very difficult to get approval for a foreign invested enterprise established purely for investment purposes or to get separate SAFE approval, in the absence of specific law providing otherwise, Circular 142 effectively prohibits the use of RMB converted from foreign currency by an investment fund to purchase equity interests in domestic enterprises.

One body of law that has made it possible to establish foreign participated RMB funds are the 2003 *Administrative Measures on Foreign Invested Venture Capital Investment Enterprise* (the "FIVCIE Rules"). Traditionally the approval process has been dissuasive to foreign fund sponsors although more recently it has been somewhat relaxed. FIVCIEs, however, still don't operate like true partnerships in the way most general partners are accustomed and are not necessarily a viable option because of the requirement under the FIVCIE Rules to primarily invest in either high tech or new technology industries.

The promulgation by the State Council of the *Administrative Measures on the Establishment of Partnership Enterprises in China by Foreign Enterprises or Individuals* and its related regulations (the “FIP Rules”) in March 2010, certainly opened the way for foreign participation in true Chinese partnership structures and in theory was supposed to involve a less rigorous qualification approval process. However, a number of issues remain unclear under the FIP Rules, including whether Circular 142 continues to apply and in practice the establishment of a FIP is still subject to a high degree of discretionary oversight.

The Pilot Qualification Program

The QFLP Rules enable foreign fund sponsors to obtain pilot qualification of a type of foreign invested enterprise (“Management FIE”) which is able to establish and manage a RMB Fund. The Management FIE may be in the form of a partnership or a limited liability company and must have a minimum cash capital commitment of US$2 million and management personnel with a five (5) year track record. A Management FIE that has obtained pilot qualification is permitted to convert up to 5% of the aggregate capital commitment of the RMB fund from foreign currency into RMB for investment into the RMB fund.

The QFLP Rules also enable foreign invested RMB funds to obtain pilot qualification (“Equity Fund FIE”). An Equity Fund FIE may be in the form of a partnership and must have minimum aggregate capital commitments of US$15 million with each limited partner no less than US$1 million. In order to obtain qualification, the foreign investors of an Equity Fund FIE must be institutional investors recognized by the Joint Conference (a group comprising various offices of the Shanghai Municipal Government) and will generally include offshore sovereign wealth funds, pension funds, endowment funds, charitable funds, funds of funds, insurance companies, banks, securities companies and other approved foreign institutional investors and must have (a) proprietary assets of no less than US$500 million or have assets under management of no less than US$1 billion for the financial year immediately preceding the application for qualification. Before applying for pilot qualification, an Equity Fund FIE is required to enter into a custody agreement with a qualified bank to open a custody account to hold its funds.

The QFLP Rules are especially significant for foreign fund sponsors who seek to establish and manage domestic or “pure” RMB funds (i.e. funds which only seek to pool domestic sources of capital) as any foreign currency converted RMB capital contribution by the general partner up to the 5% limit will not change the domestic nature of the fund. Domestic or “pure” RMB funds enjoy a number of deal making advantages because they are not subject to China’s foreign investment restrictions.

As for foreign invested RMB funds, the QFLP Rules are also significant in that a qualified Equity Fund FIE can process foreign exchange lodged with its custodian banks to make its onshore investments, and therefore it would appear without being subject to any foreign exchange restriction. Unfortunately, the accommodations in the QFLP Rules are brief to say the least, unlike the Qualified Foreign Institutional Investors regime for foreign institutional investment in the domestic stock market, which currently lacks any kind of detailed guidelines. It should be noted that the qualification of such funds does not enable the Equity Fund FIE to be treated as a domestic partnership and as such is subject to the usual restrictions on foreign investment.

Observations

The QFLP Rules do represent another significant step towards making RMB funds more viable and attractive to foreign participants and in particular, enable foreign fund managers seeking to only manage domestic sources of capital to compete on a more level playing field with their domestic counterparts.

For foreign fund sponsors seeking to attract both domestic and foreign sources of capital, there will likely still be a number of structuring options to choose from depending on the circumstances of each fund. The QFLP Rules as they stand don't quite set out the kind of detailed guidelines that private equity managers would have hoped for in terms of getting certainty over the extent that foreign currency contributed capital can be used to make RMB investments. Moreover, the investor qualification requirements will exclude smaller funds. A FIVCIE may still be a preferred structure where the nature of investments will be limited to high technology investments as the establishment thresholds are lower than for an Equity Fund FIE and parallel co-investment funds may also continue to be an option notwithstanding the perceived conflict of interest issues.

Whilst Shanghai has led the way with the QFLP Rules it is widely expected that Beijing and other provinces will soon follow with a similar and perhaps improved set of rules as the various municipalities and provinces compete for prominence in the RMB fund market.